

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
R. EDWARD TOWNSEND, JR.	:	DETERMINATION
AND SUZANNE C. NAGY	:	DTA NO. 819265
	:	
for Redetermination of a Deficiency or for Refund of	:	
New York State and New York City Personal Income Tax	:	
under Article 22 of the Tax Law and the New York City	:	
Administrative Code for the Years 1995 through 1997.	:	

Petitioners, R. Edward Townsend, Jr. and Suzanne C. Nagy, 77 Bleecker Street, New York, New York 10012, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the New York City Administrative Code for the years 1995 through 1997.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on July 17, 2003 at 10:30 A.M., continued at that location on July 18, 2003 at 9:15 A.M., and continued to conclusion at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on October 20, 2003 at 10:30 A.M., with all briefs to be submitted by June 1, 2004, which date began the six-month period for the issuance of this determination. Petitioners appeared by R. Edward Townsend, Jr., Esq., appearing *pro se* and on behalf of his wife, Suzanne C. Nagy. The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Jennifer L. Hink, Esq., of counsel).

ISSUES

I. Whether petitioners have substantiated their claimed deductions, including a theft loss of \$324,750.00, incurred by Ms. Nagy's Manhattan-based business known as Gallery Les Looms, and whether the gallery properly computed its cost of goods sold.

II. Whether penalties for negligence and for substantial underpayment of tax should be imposed.

FINDINGS OF FACT

1. Petitioner, Suzanne C. Nagy, who came to the United States from Hungary in 1978 to marry Steven Mati, was a homemaker living in Connecticut when her husband died on May 14, 1990 after a grueling four-year battle with cancer. With Mr. Mati's death, Ms. Nagy inherited a valuable collection of antique tapestries, rugs, textiles, pillows and related items from her husband's estate. This collection, which included some rare items from the 16th to 19th centuries, represented the inventory of Mr. Mati's successful Manhattan business known as Gallery Les Looms, located in the Art and Antique Center on Manhattan's upper East Side at 1050 Second Avenue, home to approximately 120 galleries. Gallery Les Looms has been at this location for approximately 30 years. The customers of the gallery were predominantly interior decorators, including ones from Europe, South America and from across the United States, as well as architects. Mr. Mati employed in the gallery Suzan Mati, his daughter (and Ms. Nagy's stepdaughter), and Zeron Ayvazian, who was viewed by Mr. Mati almost like a son and was his "left or right hand" in Ms. Nagy's words (tr. 7/17/04, p. 138). Ms. Nagy's inheritance of the gallery's inventory would quickly lead to conflict with her stepdaughter and Mr. Ayvazian, and as discussed below in Finding of Fact "29", resulted in a scheme by Ms. Mati and Zeron Ayvazian to convert a valuable portion of the inventory to their own use.

2. The collection was valued for Mr. Mati's estate as of May 14, 1990, the date of his death, by Dirk Holger, a well-respected appraiser based in Germany who has lectured on antique textiles and tapestries at the Smithsonian Institute. The estate tax return dated July 21, 1994 include approximately 50 pages listing each item in the collection with a date of death value. Some of the more valuable items included:

Item #	Description	Date of Death Value
180	16 th century biblical tapestry 13' x 8'	\$30,000.00
505	18 th century Flemish biblical tapestry 9' x 14'	\$75,000.00
517	18 th century Aubusson 8' x 9'	\$46,000.00
559	17 th century Brussels 7'9" x 6'4"	\$32,000.00
567	16 th century Flemish 7'1" x 6'6"	\$35,000.00
694	19 th century valence Aubusson (pair)	\$38,000.00
651	Persian antique Malayer rug 10' x 20'	\$40,000.00
677	Aubusson 10' x 11'	\$34,000.00
678	19 th century French needlepoint 7' x 12'	\$30,000.00
696C	Sovanerie 15' x 17'	\$40,000.00
ub 26	18 th century Aubusson 9' x 9'6"	\$49,000.00
ub 27	19 th century Aubusson 6' x 7'	\$32,000.00
ub 28	17 th century Flemish verdure 9' x 12'	\$48,000.00
Ub 30	17 th century Flemish tapestry 9'8" x 12'8"	\$58,000.00
Ub 31	17 th century Brussels tapestry 12'6" x 10'	\$65,000.00
02	Besarabian kilim 7'6" x 9'2"	\$68,000.00
05	Aubusson oval rug 10' x 20'	\$45,000.00
10	Aubusson rug 13'4" x 19'2"	\$65,000.00
11	Aubusson rug 10' x 14'	\$45,000.00
12	Tabriz 10' x 14'	\$46,000.00
15	Aubusson rug 11' x 15'	\$48,000.00
Total		\$969,000.00

The value for the entire collection shown on the estate tax return was \$2,867,790.00, which was accepted after review by the Internal Revenue Service. Mr. Mati's total gross estate was \$3,466,791.10, so that the gallery's inventory represented approximately 83% of the value of the total gross estate. Susan Mati, Ms. Nagy's stepdaughter, inherited a mere \$9,413.75, while the estate tax return shows that Ms. Nagy received \$3,313,319.35. A rider to the estate tax return describing the gallery noted that "decedent's grown daughter, Suzan Winchester (Susan Mati), who worked in the business as a restorer . . . felt she, and not decedent's wife, should inherit the business."

3. Ms. Nagy decided to carry on Mr. Mati's business utilizing the collection she had inherited, with its stepped-up basis in value as of the date of her husband's death, as her initial inventory. Petitioner R. Edward Townsend, an attorney whose wife had died in September of 1989, became Ms. Nagy's confidant and advisor and assisted her in taking over the operation of Gallery Les Looms. He also served as the attorney for Mr. Mati's estate. Ms. Nagy and Mr. Townsend were married in May of 1991.

4. An inventory, with stepped-up values, gave Ms. Nagy an incentive to adopt a method of calculating her cost of goods sold known as a specific matching or specific identity methodology whereby the inventory value of the particular item sold is subtracted from the selling price of the specific item sold. In this way, the gallery's calculation of its gross income would be greatly reduced by subtracting stepped-up values from selling prices. In adopting this methodology, petitioner ignored the traditional methodology of determining cost of goods sold based upon merchandise inventory adjustments.¹ However, petitioners filed state income tax

¹ The traditional methodology starts with a value for merchandise inventory as of the start of a period or "beginning inventory," with purchases during the period added to this "beginning inventory." The "cost of merchandise sold" for the period is then computed by subtracting a value for merchandise inventory as of the end of a period or the "ending inventory." At the end of the period, "an adjusting entry is made to transfer the cost of the

returns for the years at issue which did not clearly disclose that they had adopted this methodology. Rather they reported starting inventories, added purchases of inventory, and reported closing inventories, with the difference between starting inventories and closing inventories reported as the gallery's cost of goods sold and with the implication that they were determining an ending inventory and making merchandise inventory adjustments. This unforthcoming reporting of the gallery's cost of goods sold was further compounded by petitioners'² careless attitude with regard to maintaining records concerning the gallery's business expenses. In fact, the only "books and records" maintained by the gallery consisted of a checkbook and a handwritten inventory book which is not easily decipherable by a third party without a guided tour by Ms Nagy. No sales journal or general ledger was maintained and no bookkeeper or accountant was hired to set up a system of record keeping that could be easily audited. It was not until 2000, that petitioners hired Richard Boyd Hunter, a certified public accountant, to establish a coherent system of accounting and bookkeeping for the gallery. Furthermore, petitioners claim that many different credit cards as well as the personal checking accounts of Mr. Townsend and Ms. Nagy were used to make business purchases. In addition, business expenses were also paid by cash without an adequate concern for orderly documentation. In fact, business expenses incurred in the operation of the gallery, as noted on the tax returns at issue, were estimates.

merchandise sold to an account so named, leaving the ending inventory of merchandise as the balance of the asset account" (P. Fess & C. Niswonger, Accounting Principles [13th Edition], p. 138).

² Mr. Townsend, a practicing attorney, was very involved in providing advice to his wife Ms. Nagy concerning the operation of the gallery that sometimes included active involvement in its operation especially with regard to its tax and financial reporting as well as its record-keeping or lack thereof.

5. By a letter dated January 28, 1999, petitioners were notified by the State's auditor, Myoung Lee,³ that their income tax returns for the years 1995, 1996 and 1997 had been selected for a *detailed* audit and that they make available for examination, at an appointment scheduled two weeks later on February 11, 1999, the following information: (i) copies of Federal income tax returns and supporting schedules, (ii) all books, records, worksheets, schedules and other documents pertinent to the preparation of their tax returns including general ledgers, cash receipts journals, cash disbursements journals, payroll ledger, sales/receipts journals, trial balances and adjusting journal entries, (iii) all withholding returns filed with the IRS and New York State and relevant documents, (iv) bank records including business and personal savings and checking account statements, and canceled checks for the three years under audit, (v) documentation supporting cost of goods sold and business deductions for Ms. Nagy's business, (vi) documentation supporting itemized deductions claimed, (vii) all brokerage account statements, (viii) documentation for the sale of home, and (ix) documentation for partnership income.

6. At the initial appointment in early February of 1999, petitioners did not make available to the auditor for examination the documents itemized in his letter. By a letter dated April 14, 1999, the auditor again requested the same documents listed above and noted that he had not yet received such information although petitioners "promised to send the requested information within 30 days."

7. Two months later, by a letter dated June 11, 1999, the auditor made a third written request for the documents listed above and noted that "it is our policy to examine all open years" and that he would not be "narrowing the audit scope." This June letter of the auditor referenced

³ Auditor Lee died on September 11, 2001 in the terror attack on Manhattan's World Trade Center. Much of the Division's audit file in this matter was destroyed.

a letter dated May 3, 1999 of petitioners which was not included in the record, but presumably had requested that the auditor narrow the audit to the first year at issue, 1995. It was in the words of Mr. Townsend “a huge amount of work” to pull together the documents for even the first year at issue:

[W]e had two deaths. We have got ill parents. . . . We had children to raise. We were selling houses. . . . We had files in half a dozen different locations, and so forth. (Tr. of Oct. 20, 2003, pp 139-140).

Mr. Townsend was also puzzled why petitioners’ tax returns had been selected for audit and felt that if he could determine what had “triggered” the audit, he could respond in a specific fashion and avoid the burdens of facing a detailed audit of all of petitioners’ records for a three-year period. An attorney, with an assertive style, Mr. Townsend was frustrated by the auditor’s refusal to provide any explanation why he and his wife, Suzanne C. Nagy, had been selected for a grueling audit, and began to dig in his heels in responding to the auditor’s demands. In his letter dated June 19, 1999, in response to the auditor’s third written request for all records for a three-year period, Mr. Townsend responded curtly and somewhat emotionally:⁴

As previously indicated, we are trying to finish up our 1998 income tax returns, and also trying to make a living, and so have not been able to devote sufficient

⁴ A goal for an attorney is to help a client view a dispute in an objective way. Special difficulties arise when an experienced attorney, trained to be an advocate, represents himself or family. Mr. Townsend became very frustrated with auditor Lee who he complained “couldn’t or wouldn’t understand how the business worked,” and he litigated this matter in an unusually aggressive fashion. For reasons of many other demands on his time and annoyance at the Division’s refusal to modify its request for all of the gallery’s documents for the three years, Mr. Townsend did not gather up all of petitioners’ documents, which would substantiate the gallery’s operation for all three years at issue, until the hearing in this matter. Even then, petitioners did not comply with 20 NYCRR 3000.14 which requires the preparation and submission of a hearing memorandum not less than 10 days before the hearing date which includes a list of all exhibits to be introduced at hearing. Further, Mr. Townsend at the very start of the hearing indicated that he still wasn’t able to show the taxpayers’ exhibits to the Division because he was not certain what exhibits they would be putting into the record. His justification was based on his contention that if petitioners established entitlement to the theft loss, “all of the rest of this becomes meaningless, because there is a huge carry forward” (tr. 7/17/03, p. 20). Nonetheless, at the direction of the administrative law judge, he was required to bring forward all of his documents for identification and marking before proceeding substantively if he wanted them to be considered in this matter. On the first day of the hearing, petitioners offered for identification 53 exhibits, what they had brought with them. The administrative law judge permitted Mr. Townsend to specify what additional documents he would be bringing the next day. However, even as of the start of the second day of the hearing, petitioners were still considering whether or not to provide third-party proof of expenses. In total, petitioners had 83 exhibits marked for identification in this proceeding. Some, however, were never introduced into evidence.

time putting together what you want until we finish our 1998 returns. Yes, a period of time has passed, but you have asked for everything under the sun with respect to the prior three years, and it will take time [I]f you make an assessment, we will have to contest it and then be forced to introduce every receipt into evidence before the Administrative Law Judge, which would be an enormous waste of the State's time and money. You will get everything you want as soon as we can get to it.

8. Approximately eight months later, by a letter dated February 18, 2000, the auditor made a fourth and final request for information and explained that if it was not provided by March 10, 2000, "an estimated assessment including tax, penalty and interest will be developed based upon current information." In response, by a letter dated February 23, 2000, with a copy sent to the governor, Mr. Townsend indicated that he felt he and his wife were being subjected "to the very worst kind of taxpayer harassment" He simply could not understand why the auditor would not first look at their documents for the first year at issue before requiring them to produce "every single thing that affected our taxes for the years 1995 through 1997."

9. By a letter dated March 24, 2000, auditor Lee finally agreed that "[t]he 1995 information prepared [by petitioners] will be examined first." By a letter dated March 26, 2000, Mr. Townsend responded by offering to provide the 1995 information at his office on April 28, 2000 for as many days as the auditor needed. Auditor Lee observed in an entry in his log dated March 1, 2000: "Something unusual was noted: Too high inventory level comparing to sales amount, large change in dividend income between audit years." Petitioners reported dividend income of \$532.00, \$16.00, and \$13,559.00 in 1995, 1996, and 1997, respectively.

10. Apparently an examination of petitioners' documents for 1995 did not occur in Mr. Townsend's office in late April since by a letter dated May 3, 2000, Mr. Townsend noted that his "wife's and my original files with respect to our 1995 taxes" were being hand-delivered to auditor Lee's office on the 86th floor of 2 World Trade Center.

11. A few days later, by a letter dated May 8, 2000, the auditor requested certain additional information as follows: (i) first page of the bank statement for the period 1/21/95 - 2/17/95 and full pages of bank statements for 2/18/95-8/17/95, (ii) a sales book or summary of cash receipts, including invoices to customers, supporting Schedule C gross receipts, (iii) inventory log or summary of inventory for each month of 1995 showing beginning inventory, ending inventory and inventory in and out; (iv) explanation of method used to value closing inventory and explanation for very high level of inventory in comparison with sales; (v) reconciliation of canceled checks provided of \$227,181.00 and amount for purchases shown on tax return of \$471,517.00.

12. Five months later, by a letter dated October 4, 2000, the auditor sent a workpaper which included notations indicating the need for additional information including: (i) breakdown of disbursements in the total amount of \$137,493.00 from a Merrill Lynch account into “each expense category along with appropriate invoices,” (ii) documentary evidence to support amounts claimed on petitioners’ Schedule A for real estate tax and home mortgage interest and points, (iii) details to explain difference of \$244,336.00 in purchases of inventory (representing the difference between the \$471,517.00 claimed by petitioners on their return and \$227,336.00 per audit, (iv) details to explain differences in selling expenses claimed per return and per audit of \$47,848.00 (representing the difference between the \$212,789.00 claimed by petitioners on their return and \$164,941.00 per audit). This request for additional information was based upon a review by the auditor of the 1995 information provided by petitioners which included an audit appointment on September 12, 2000 at Mr. Townsend’s office.

13. By a letter dated November 8, 2000, petitioners provided the auditor with further information including a “break-out of the sales in three categories,” namely, (i) sales from Ms.

Nagy's inheritance of inventory, (ii) sales from inventory other than inheritance, and (iii) sales of consigned merchandise. Information was also provided concerning losses from the theft of merchandise, and why deposits into the business are the best evidence of sales rather than invoices since "this is a business of negotiations" and new invoices are not prepared after pricing is renegotiated. In addition, on December 27, 2000, Mr. Lee conducted an audit appointment at Mr. Townsend's office where he rejected petitioners' argument that an inventory loss of \$324,750.00 should be allowed in 1995.

14. On March 6, 2001, auditor Lee sent petitioners his adjustments for 1995 and again requested information for 1996 and 1997.

15. Mr. Townsend responded with a letter dated March 14, 2001 to William McClellan, the supervisor of auditor Lee, demanding that Mr. Lee "be removed from this case" because "*Mr. Lee threatened us with further audits of 1998 and 1999, if I did not, or was not able to, furnish him with exactly what he wanted on the precise day he wanted it [emphasis in original].*" Mr. Townsend emphasized that his wife's business had a \$324,750.00 loss in 1995 which Mr. Lee would not allow. In Mr. Townsend's view, if this loss was allowed, there would be no liability for any of the years at issue, and he argued vigorously that "This is the issue which must be resolved before proceeding to years 1996 and 1997." He suggested that he and the Audit Division should stipulate to a trial before an administrative law judge of only this one issue⁵ apparently assuming that he could reserve the resolution of other issues to a later hearing date if necessary.

⁵ There is no provision in the Tax Law or regulations that permits the resolution of one issue prior to a hearing on other issues. Rather, the practice and procedure of the Division of Tax Appeals is to require all issues raised in a petition to be addressed at a hearing once "issue is joined" (20 NYCRR 3000.15). Further, a hearing is not obtainable until a petition and responsive pleadings have been filed (*see*, 20 NYCRR 3000.4).

16. Supervisor McClellan responded in a letter dated April 27, 2001 informing Mr. Townsend that a notice of deficiency would be issued for all years “based on the information available to us” in light of the State’s receipt of “only part of the documentation we have requested” after numerous requests.

17. Mr. Townsend replied by a letter dated June 1, 2001 restating his opinion that “[t]he magnitude of the 1995 loss directly affects tax years 1996 and 1997, and that is why I have insisted on resolving that issue before moving on, which I feel is the reasonable and efficient thing to do.” He also complained vigorously that auditor Lee “chose to do things the long, slow way, which is his prerogative, I assume, but that takes much more of my time, requires more preparation, etc.” According to Mr. Townsend, this expenditure of time and effort by Mr. Lee had “not come up with anything,” and he expressed frustration that “*Mr. Lee’s threat to punish us further by auditing additional years* [emphasis in original]” was not addressed.

18. Approximately two weeks later, the Division of Taxation (“Division”) issued a Notice of Deficiency dated June 18, 2001 against R. Edward Townsend, Sr. and Susan Mati⁶ asserting New York State and City personal income tax due of \$99,332.20, plus penalty and interest, as follows:

Year	Tax Asserted Due
1995	NYS income tax of \$23,141.63
1995	NYC income tax of \$13,194.50
1996	NYS income tax of \$29,996.19

⁶ The Notice of Deficiency does not reference petitioner Suzanne C. Nagy but rather a Susan Mati. The daughter of Suzanne C. Nagy’s former husband who died in May of 1990, as noted in Finding of Fact “1”, was a Suzan Mati. In addition, this notice references an R. Edward Townsend, *Sr.* not R. Edward Townsend, *Jr.*

1996	NYC income tax of \$18,399.59
1997	NYS income tax of \$9,025.70
1997	NYC income tax of \$5,574.59
Total tax asserted due	\$99,332.20

This Notice of Deficiency provided the following brief explanation: “Field audit of your records disclosed additional tax due.”

19. A month earlier, the Division had prepared⁷ three statements of personal income tax audit changes for 1995, 1996 and 1997, respectively, each dated May 10, 2001, which showed how the tax asserted due in the Notice of Deficiency, was calculated.

For 1995, the Division computed a corrected New York taxable income for petitioners of \$315,926.00 as follows:

Description	Amount
New York adjusted gross income per return	\$87,613.00
Audit increases to income: Gross receipts underreported, \$ 72,028.00 Purchases disallowed 172,586.00 Business expenses disallowed 36,458.00 Total audit increases \$281,072.00 Audit decreases -0- Net adjustments to New York adjusted gross income	\$281,072.00
Corrected adjusted gross income	\$368,685.00
Itemized deductions per return	69,012.00
New York itemized deduction adjustment ⁸	(17,253.00)
Corrected itemized deductions after modification	51,759.00

⁷ Petitioners assert that they did not receive the statements of personal income tax audit changes until the conciliation conference on May 21, 2002.

⁸ This is an automatic adjustment to petitioner’s itemized deductions based on the audit increases to the taxpayers’ income and does not represent a disallowance of any specific Schedule A deductions.

New York exemptions allowed	1,000.00
Corrected New York taxable income	\$315,926.00

Utilizing the corrected New York taxable income shown above of \$315,926.00, the Division calculated corrected New York State tax liability of \$23,927.63 and New York City tax liability of \$13,688.50. After allowing a credit for New York State and New York City tax previously paid of \$786.00 and \$494.00, respectively, the Division asserted an additional total tax liability for 1995 of \$36,336.13 consisting of an additional New York State income tax liability of \$23,141.63 and additional New York City income tax liability of \$13,194.50. Further, a negligence penalty and a penalty for substantial understatement of liability were imposed, plus interest.

For 1996, the Division computed a corrected New York taxable income for petitioners of \$442,093.92 as follows:

Description	Amount
New York adjusted gross income per return	\$93,773.00
Audit increases to income:	
Gross receipts underreported	\$44,704.00
Purchases disallowed	155,188.00
Business expenses disallowed	192,721.00
Total audit increases	\$393,613.00
Audit decreases	-0-
Net adjustments to New York adjusted gross income	\$393,613.00
Corrected adjusted gross income	\$487,386.00
Itemized deductions per return	64,371.00
New York itemized deduction adjustment ⁹	(20,078.92)

⁹ As in the earlier audit year of 1995, this is an automatic adjustment to petitioners' itemized deductions based on the audit increase to their income and does not represent a disallowance of any specific Schedule A deductions.

Corrected itemized deductions after modification	44,292.08
New York exemptions allowed	1,000.00
Corrected New York taxable income	\$442,093.92

Utilizing the corrected New York taxable income shown above of \$442,093.92, the Division calculated corrected New York state tax liability of \$31,499.19 and New York City tax liability of \$19,392.59. After allowing a credit for New York State and City tax previously paid of \$1,503.00 and \$993.00, respectively, the Division asserted an additional total tax liability for 1996 of \$48,395.78 consisting of an additional New York State income tax liability of \$29,996.19 and additional New York City income tax liability of \$18,399.59. Further a negligence penalty and a penalty for substantial understatement of liability were imposed, plus interest.

For 1997, the Division computed a corrected New York taxable income for petitioners of \$131,762.00 as follows:

Description	Amount
New York adjusted gross income per return	\$31,096.00
Audit increases to income:	
Gross receipts underreported	\$32,351.00
Purchases disallowed	1,690.00
Business expenses disallowed	124,645.00
Total audit increases	\$158,686.00
Audit decreases	-0-
Net adjustments to New York adjusted gross income	\$158,686.00
Corrected adjusted gross income	\$189,782.00
Itemized deductions per return	\$57,020.00
New York itemized deduction adjustment	-0-
New York itemized deductions allowed	\$57,020.00
New York exemptions allowed	\$1,000.00

Corrected New York taxable income	\$131,762.00
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Utilizing the corrected New York taxable income shown above of \$131,762.00, the Division calculated corrected New York State tax liability of \$9,025.70 and New York City tax liability of \$5,574.59. The Division asserted an additional total tax liability for 1997 of \$14,600.29 consisting of the sum of these two amounts since it allowed no credit for New York State and New York City tax previously paid. Further, a negligence penalty and a penalty for substantial understatement of liability were imposed, plus interest.

20. Petitioners filed joint New York State resident income tax returns for each of the years at issue and reported the income and claimed expenses from the operation of Susanne Nagy's tapestry business known as Gallery Les Looms as Schedule C (Profit or Loss from Business) business income, for 1995 and 1996, and business loss, for 1997.¹⁰ They also reported nonpassive income from Mr. Townsend's law partnership of \$52,742.00, \$87,737.00, and \$98,398.00, for 1995, 1996, and 1997, respectively, and New York adjusted gross income of \$87,613.00, \$93,773.00 and \$31,096.00 for 1995, 1996 and 1997, respectively.

For 1995, petitioners on their tax return reported income from the gallery of \$41,157.00 based upon gross income of \$253,946.00 and total expenses of \$212,789.00.¹¹ Gross income of \$253,946.00 was computed as follows:

Description	Amount
Gross receipts or sales	\$544,660.00

¹⁰ Ms. Nagy operated her business as a sole proprietorship up until July 1997, when the business was incorporated.

¹¹ Ms. Nagy in an affidavit dated December 22, 2000 stated that a "theft loss (having become uncollectible) was taken as a deduction on my income tax returns for 1995, although the loss taken was significantly understated." No such type of loss is included in the total expenses reported of \$212,789.00. It is unclear where it might have been shown on the return though petitioners have contended that the gallery's inventory should be reduced by the amount of any theft loss.

Returns and allowances	-0-
Cost of goods sold	290,714.00
Gross income	\$253,946.00

Petitioners reported total expenses of \$212,789.00 calculated as follows:

Description	Amount
Car and truck expenses	\$ 7,991.00
Insurance	9,816.00
Legal and professional services	1,413.00
Rent	39,210.00
Supplies	21,406.00
50% of meals and entertainment of \$6,545.00	3,273.00
Utilities	1,324.00
Wages	80,354.00
Other expenses:	
Trucking, UPS & custom fees	\$ 9,670.00
Telephone	7,562.00
Catalogues	5,916.00
Out of town travel	21,379.00
Commercial rent tax	2,072.00
Miscellaneous expenses	127.00
Local transportation	1,277.00
Total other expenses:	\$48,003.00
Total expenses	\$212,789.00

For 1996, petitioners reported income from the tapestry business of \$30,725.00 based upon gross income of \$223,446.00 and total expenses of \$192,721.00. The gross income of \$223,446.00 was computed as follows:

Description	Amount
Gross receipts or sales	\$ 338,040.00 ¹²

¹² In early June 2003, just prior to the start of the hearing in this matter, the Division's auditor, Jean Baptiste Niakadie, performed an analysis of the Chase business checking statements of the tapestry business and determined that its deposits totaled \$405,743.58, an amount in excess of what was reported by petitioners.

Returns and allowances	-0-
Cost of goods sold	114,594.00
Gross income	\$ 223,446.00

Total expenses reported of \$192,721.00 were calculated as follows:

Description	Amount
Advertising	\$2,140.00
Car and truck expenses	8,812.00
Commissions and fees	2,100.00
Insurance	2,233.00
Rent	43,424.00
Supplies	22,460.00
50% of meals and entertainment of \$1,301.00	650.00
Utilities	1,182.00
Other expenses:	
Trucking, UPS & custom fees \$	5,617.00
Telephone	7,875.00
Catalogues	43.00
Out of town travel	17,918.00
Commercial rent tax	597.00
Local transportation	1,131.00
Unincorporated business tax	1,246.00
Storage	1,210.00
Painting and cleaning	4,800.00
Gifts	579.00
Outside services	68,704.00
Total other expenses \$	109,720.00
Total expenses	\$ 192,721.00

For 1997, petitioners reported a *loss* of \$55,599.00 from the operation of the tapestry business based upon gross income of \$69,046.00 and total expenses of \$124,645.00. The gross income of \$69,046.00 was computed as follows:

Description	Amount
Gross receipts or sales	\$ 244,633.00

Returns and allowances	-0-
Cost of goods sold	175,587.00
Gross income	69,046.00

Total expenses reported of \$124,645.00 were calculated as follows:

Description	Amount
Car and truck expenses	\$ 4,260.00
Commissions and fees	1,273.00
Insurance	2,858.00
Legal and professional services	750.00
Rent	28,800.00
Supplies	7,301.00
50% of meals and entertainment of \$4,437.00	2,218.00
Utilities	707.00
Other expenses:	
Trucking, UPS & custom fees	\$1,972.00
Telephone	5,738.00
Catalogues	397.00
Out of town travel, hotel & auto rental	12,180.00
Dues	30.00
Local transportation	1,197.00
Outside services	54,964.00
Total other expenses	\$ 76,478.00
Total expenses	\$124,645.00

21. As indicated in Finding of Fact “20”, petitioners reported on their tax returns, the cost of goods sold for 1995 of \$290,714.00, for 1996 of \$114,594.00, and for the portion of 1997 when the gallery was operated as a proprietorship of \$175,587.00.

For 1995, the cost of goods sold of \$290,714.00 was calculated on the return as follows:

Inventory at beginning of year	\$3,466,516.00
Purchases less cost of items withdrawn for personal use	471,517.00
Total	3,938,033.00

Inventory at end of year	3,647,319.00
Cost of goods sold	\$ 290,714.00

For 1996, the cost of goods sold of \$114,594.00 was calculated on the return as follows:

Inventory at beginning of year	\$3,647,319.00
Purchases less cost of items withdrawn for personal use	156,188.00
Total	3,803,507.00
Inventory at end of year	3,688,913.00
Cost of goods sold	\$114,594.00

For 1997, the cost of goods sold of \$175,587.00 was calculated on the return as follows:

Inventory at beginning of year	\$3,688,913.00
Purchases less cost of items withdrawn for personal use	1,690.00
Total	3,690,603.00
Inventory at end of year	3,515,016.00
Cost of goods sold	\$175,587.00

At the hearing, petitioners offered into evidence three documents, which Ms. Nagy explained represented a summary of the gallery's purchases of inventory during the period at issue, with some related invoices. These documents (Exhibits "71", "72" and "73") support a finding that the gallery's purchases of inventory totaled \$801,739.00 over the period at issue consisting of \$419,919.00 in 1995, \$227,344.00 in 1996, and \$154,476.00 in the portion of 1997 at issue (through July 20, 1997). Nonetheless, these amounts are not reflected in any fashion in the calculation of cost of goods sold reported on petitioners' tax returns as noted above or in their calculation of cost of goods sold as detailed below in Finding of Fact "27". Instead, based upon evidence introduced at the hearing, petitioners now claim cost of goods sold for 1995 of \$340,095.00, for 1996 of \$187,240.00, and for 1997 of \$155,950.00.

22. The first year at issue, 1995, was audited by Myoung Lee. After reviewing the expense records of Ms. Nagy's tapestry business, Mr. Lee disallowed \$36,458.00 of the

\$212,789.00 total expenses claimed by the business, or, in other words, he allowed \$176,331.00 of the total expenses claimed. Nearly all of the Division's original audit file, including Mr. Lee's audit papers, were destroyed in the World Trade Center. However, petitioners introduced into evidence a copy of Mr. Lee's letter dated March 6, 2001 to them noting that:

Based on the substantiation, the Schedule A issue has been cleared and the other additional expenses have been properly added to each expense category.

Mr. Lee included with this letter a schedule entitled "Tracing of Income & Expenses to Source Documents," which detailed his allowance of claimed expenses by Ms. Nagy's tapestry business for 1995 in the amount of \$176,331.00 as follows:

Expense Item	Per return	Per Mr. Lee's audit
Car & truck	\$ 7,991.00	\$ 4,208.00
Commission & fees	-0-	450.00
Insurance other than health	9,816.00	4,055.00
Legal & professional	1,413.00	-0-
Rent or lease	39,210.00	30,210.00
Supplies	21,406.00	14,169.00
Meals & entertainment (50%)	3,272.00	-0-
Utilities	1,324.00	1,325.00
Wages	80,354.00	76,854.00
Trucking, UPS & custom fees	9,670.00	2,960.00
Telephone	7,562.00	7,562.00
Catalogues/printing	5,916.00	5,911.00
Out of town travel	21,379.00	16,990.00
Commercial rent tax	2,072.00	1,802.00
Local transportation	1,277.00	-0-
Misc Expenses	127.00	380.00
License	-0-	455.00
Total selling expenses	\$212,789.00	\$176,331.00

Auditor Lee's schedule included a column labeled "remarks." On the line where he allowed \$76,854.00 in wages, he noted the amount not allowed of \$3,500.00 was "attributable to small payments for which 1099 not required." On the line where he allowed supplies amounting to \$14,169.00, he noted that of this amount \$9,816.00 were credit card charges. On the line where he allowed miscellaneous expenses of \$380.00, he noted "Manhattan Mini Storage." On the line where he allowed car and truck expenses of \$4,208.00, he noted "50% Allowed (\$8,417)." Mr. Lee in his letter of March 6, 2001 also explained that "theft losses can be deducted only in the year that the theft was discovered" and rejected petitioners' deduction for any theft loss.

23. As noted in Finding of Fact "19", Mr. Lee also increased petitioners' income for 1995 by \$172,586.00 for "purchases disallowed" despite the fact that the business as operated by Ms. Nagy did *not* expense the purchase price of its inventory in the year of purchase. Ms. Nagy calculated income from the sale of rugs and tapestries based upon a specific matching or specific identity method of determining income on the sale of an item, by subtracting the cost of the specific item from the receipt from the sale of the item. As explained by the accountant who prepared petitioners' tax returns for the years at issue, including the respective Schedules "C":

No matter what the purchases are, the cost of goods sold does not change, since taxpayers matched sales to the exact costs of items sold from inventory.

24. Subsequent to the two days of hearing in Manhattan on July 17th and 18th, 2003, the State by its auditor, Jean Niakadie, after reviewing evidence introduced by petitioners on these dates, prepared revised workpapers which show audited amounts for "cost of goods sold" as follows:

	Per Petitioners' Tax Return	Auditor Niakadie's review ¹³
1995 cost of goods sold	\$290,714.00	\$295,214.00
1996 cost of goods sold	114,594.00	161,628.00
1997 cost of goods sold	175,587.00	138,675.00

As noted in Finding of Fact "22", auditor Lee also had disallowed \$36,458.00 of the \$212,789.00 total expenses claimed by the business. Subsequent to his review of petitioners' evidence introduced at the hearing conducted in Manhattan, Mr. Niakadie also allowed an expense in the amount of \$22,732.00 representing a "bad debt from sales or services."

25. As noted in Finding of Fact "19", auditor Lee disallowed all of the business expenses of the gallery claimed on petitioners' tax return in 1996 of \$192,721.00 and in 1997 of \$124,645.00 on the basis that they provided no substantiation. Auditor Niakadie, who succeeded Mr. Lee, also refused to allow any expenses claimed by the business for 1996 and 1997 because "I didn't have any bills and invoices which is different from Mr. Lee [who] had seen something [for 1995]. . ." (tr., p. 73). Mr. Townsend, a practicing lawyer, and Ms. Nagy, actively engaged in her gallery, were hard pressed for time. Faced with the succeeding auditor's demands that they provide backup documentation for *all* of the expenses incurred by the tapestry business, attorney Townsend reacted in frustration and anger refusing to disclose any documentation prior

¹³ Mr. Niakadie calculated an amount representing cost of goods sold by starting with the inventory value at the beginning of the year, adding the amount of purchases of inventory during the year to get a subtotal, and then subtracting an amount representing the value of inventory at the end of the year to get cost of goods sold. For example, in 1996:

Inventory at beginning of year	\$3,647,319.00
Purchases during 1996	203,222.00
Subtotal	3,850,541.00
Inventory at end of year	3,688,913.00
Cost of goods sold	\$ 161,628.00

to the hearing in this matter other than the canceled checks and bank statements for the business. Petitioners simply could not understand why the auditor and the State's attorney would not allow, based upon canceled checks, "items such as rent, utilities, telephone, insurance, etc." (Exh. L, p. 90) as deductions for an operating business without petitioners first providing bills and receipts for such items when they had already been audited for 1995 in a thorough fashion. In contrast, the Division has rigorously maintained its position that it is "always crucial to see the actual bills that a business has in order to fully assess the legitimacy of the figures cited by any taxpayer" (Exh. L. p. 93).

26. At the hearing, petitioners finally offered substantiation of the gallery's expenses which included third-party documentation such as bills and invoices for 1996 and 1997. Subsequent to his review of petitioners' evidence introduced at the first two days of hearing conducted in Manhattan, auditor Niakadie allowed business expenses in 1996 of \$149,826.00 and in 1997 of \$117,997.00 consisting of the following:

Item of Expense	Amount allowed for 1996	Amount allowed for 1997
Advertising	\$700.00	\$7,139.00
Car & truck expenses	\$9,268.00	5,234.00
Commissions & fees	\$1,800.00	-0-
Insurance	\$2,863.00	1,620.00
Legal & professional services	-0-	750.00
Other business property	\$41,961.00	28,036.00
Supplies	\$5,499.00	2,272.00
Travel	\$600.00	-0-
Meals & Entertainment	\$509.00	-0-
Utilities	\$1,182.00	777.00
Trucking, UPS & Custom fees	\$2,065.00	1,134.00
Telephone	\$6,869.00	3,470.00
Catalogues	\$86.00	65.00

Commercial rent tax	\$597.00	-0-
Miscellaneous expense	\$164.00	134.00
Local transportation	\$1,131.00	1,197.00
Unincorporated business tax	-0-	-0-
Storage	\$1,256.00	-0-
Painting & cleaning	\$389.00	-0-
Gifts	-0-	-0-
Bank service fee	\$243.00	378.00
Computer	\$180.00	-0-
Credit card payments	-0-	-0-
Petty cash	\$4,810.00	-0-
Outside services	\$67,654.00	65,198.00
Printing	\$1,426.00	253.00
Licenses	-0-	340.00
Total	\$149,826.00	\$117,997.00

27. At the hearing, in the course of Ms. Nagy's testimony and the introduction of three lengthy exhibits ("28", "33", and "47"), petitioners established the gallery's cost of goods sold for 1995 of \$340,095.00, for 1996 of \$187,540.00 and for 1997 of \$155,950.00, which vary substantially from the amounts shown for the gallery's cost of goods sold as reported on petitioners' tax returns of \$290,714.00 for 1995, \$114,594.00 for 1996 and \$175,587.00 for 1997, as noted in Finding of Fact "21". Petitioners do not contest the fact that the amounts reported on their returns were inaccurate. Rather, through the lengthy testimony of Ms. Nagy which explained three complicated and detailed documents created for purposes of the hearing, petitioners have established the actual cost of goods sold by the gallery. These documents list the particular items sold and the basis or cost for each item. They include pages from the gallery's inventory book and other back-up information. For example, for the month of January

1996, details are provided concerning the purchaser, an item #, sale price, cost of the item sold and profit on the sale as follows:

Purchaser	Item	Sale	Cost	Profit
Shaefer	95/811	\$3,000.00	\$2,500.00	\$500.00
Heller/Sheila	96/305 consign	\$10,000.00	\$6,800.00	\$3,200.00
Darrell	774	\$10,000.00	\$6,000.00	\$4,000.00
Oliver	95/816	\$3,700.00	\$1,400.00	\$2,300.00
Doyles	61		\$700.00	(\$700.00)
Doyles	96/120	\$800.00	\$160.00	\$640.00
Cumlliae	520	\$350.00	\$200.00	\$150.00
Nutney	96/31	\$850.00	\$600.00	\$250.00
Hunt	56	\$900.00	\$700.00	\$200.00
Totals		\$29,600.00	\$19,060.00	\$10,540.00

28. During 1995, the gallery incurred four losses. The first involved the purchase of a Tabriz rug for \$18,000.00 by an individual whose check in payment bounced. The second involved the theft of an Isfahan carpet which had been purchased prior to 1995 for \$4,500.00. The third involved the theft in Hungary of a duffel bag of rugs which were purchased by the gallery during their trip to Hungary for \$4,000.00. The Division has agreed that petitioner incurred these three losses.

29. The gallery also claims a loss in the amount of \$324,750.00 for rugs which were stolen from the gallery by Zeron Ayvazian with the collusion of Suzan Mati, the daughter of Steven Mati (and Ms. Nagy's stepdaughter). In 1991, when Ms. Nagy took over the operation of the gallery, she discovered that there were a considerable number of rugs from the gallery's inventory which were out on consignment as arranged by Mr. Ayvazian to a number of Armenian dealers on the Eastern seaboard and Canada. When she began to call these dealers to check on the consignments, they refused to deal with her since they believed Mr. Ayvazian was

the owner of the gallery. When she confronted Mr. Ayvazian, he left the gallery and opened a competing gallery two blocks away with the help of Ms. Nagy's stepdaughter, Suzan Mati. For a short period after Mr. Ayvazian left, Ms. Mati continued to work at the gallery until Ms. Nagy discovered that she was diverting the gallery's customers to Mr. Ayvazian's gallery. Ms. Mati then left to join Mr. Ayvazian in the operation of his gallery. Petitioners have specified the 74 rugs which had been consigned and their total value of \$324,750.00 based on the appraisal of Dirk Holger who included these 74 rugs, with their value of \$324,750.00 in his total appraised value of \$2,867,790.00 for the inventory inherited by Ms. Nagy, as detailed in Finding of Fact "2". Not one of the 74 rugs has ever been returned to the gallery. Petitioners assert that they should be able to reduce their closing inventory by \$324,750.00 in 1995 when their lawsuit to recover some of the rugs became fruitless when a counterfeit document prepared by Ms. Nagy's stepdaughter was used as proof by the defendant to establish that the consigned rugs at issue had been returned to the gallery. The counterfeit document had the date of Mr. Mati's funeral as the date when the rugs were returned and was on a form which was not in existence as of that date but rather was used by Ms. Nagy when she took over the operation. Further, in 1995, petitioners after hiring an investigator determined that Mr. Ayvazian lacked assets and was judgment proof. Petitioners seek to account for the three losses described in Finding of Fact "28" and this large loss of \$324,750.00 by adding them to their cost of goods sold for 1995.

30. Petitioners claim that the gallery included in its deposits social security payments Ms. Nagy received on account of her daughter, Lina Mati, by reason of the death of her husband (Lina's father), Steven Mati. Auditor Lee removed social security payments of \$9,648.00 from the gallery's gross income for 1995. In 1996, petitioners claim social security payments of \$9,075.00 were also included in the gallery's deposits.

SUMMARY OF THE PARTIES' POSITIONS

31. The Division maintains that the auditors acted properly in their unwillingness to make even the smallest assumption as to what is a legitimate business expense or not when no back-up is provided in what was “a routine schedule C audit” (tr. 7/17/04, p. 25). In the words of the supervising auditor, “If you don’t have any invoices to substantiate your numbers, it’s not good enough for the department” (tr. 7/17/04, p. 58). In his opinion, checks alone are insufficient: “[I]f you wrote a check it’s not necessarily that it’s a business expense” (tr. 7/17/04, p. 66). The Division contends that petitioners were uncooperative and intentionally delayed the audit process, but nonetheless it was willing to review the evidence brought forward by them at the hearing to substantiate the business expenses of Ms. Nagy’s tapestry business. The Division after its review of petitioners’ evidence introduced at hearing noted its agreement in its brief to allow¹⁴ various expenses, in a detailed analysis which set forth a comparison of expenses as claimed on petitioners’ tax returns to figures asserted by petitioners in their initial brief, as follows:

Expense Item	\$1,995.00	1996	1997
<i>(1) Advertising</i>			
(i) Claimed on return	-0-	\$2,140.00	-0-
(ii) Asserted in petitioners’ brief	-0-	700.00	7,139.00
(iii) Allowed by Department	-0-	700.00	7,139.00
<i>(2) Catalogues & Printing</i>			
(i) Claimed on return	\$5,916.00	43.00	397.00
(ii) Asserted in petitioners’ brief	\$5,911.00	1,426.27	253.28

¹⁴ The expenses shown allowed for 1995 were based on Mr. Lee’s audit of such year, which as noted in Finding of Fact “22”, resulted in the allowance of \$176,331.00 of the total expenses claimed by petitioners of \$212,789.00.

(iii) Allowed by Department	\$5,911.00	1,426.00	253.00
<i>(3) Commercial rent tax</i>			
(i) Claimed on return	\$2,072.00	597.00	-0-
(ii) Asserted in petitioners' brief	\$1,802.00	596.70	-0-
(iii) Allowed by Department	\$1,802.00	597.00	-0-
<i>(4) Commissions & fees</i>			
(i) Claimed on return	-0-	2,100.00	1,273.00
(ii) Asserted in petitioners' brief	\$450.00	1,800.00	-0-
(iii) Allowed by Department	\$450.00	1,800.00	-0-
<i>(5) Dues</i>			
(i) Claimed on return	-0-	-0-	30.00
(ii) Asserted in petitioners' brief	-0-	-0-	-0-
(iii) Allowed by Department	-0-	-0-	-0-
<i>(6) Insurance</i>			
(i) Claimed on return	\$9,816.00	2,140.00	2,858.00
(ii) Asserted in petitioners' brief	\$4,055.00	2,863.00	1,620.00
(iii) Allowed by Department	\$4,055.00	2,863.00	1,620.00
<i>(7) Miscellaneous</i>			
(i) Claimed on return	\$127.00	-0-	-0-
(ii) Asserted in petitioners' brief	\$380.00	164.44	134.00
(iii) Allowed by Department	\$380.00	164.00	134.00
<i>(8) Painting & cleaning</i>			
(i) Claimed on return	-0-	4,000.00	-0-

(ii) Asserted in petitioners' brief	-0-	388.53	-0-
(iii) Allowed by Department	-0-	389.00	-0-
<i>(9) Telephone</i>			
(i) Claimed on return	\$7,562.00	7,875.00	5,738.00
(ii) Asserted in petitioners' brief	\$7,562.00	6,689.18	3,469.97
(iii) Allowed by Department	\$7,562.00	6,869.00	3,470.00
<i>(10) Utilities</i>			
(i) Claimed on return	\$1,324.00	1,182.00	707.00
(ii) Asserted in petitioners' brief	\$1,325.00	1,182.00	777.00
(iii) Allowed by Department	\$1,325.00	1,182.00	777.00
<i>(11) Car & truck</i>			
(i) Claimed on return	\$7,991.00	8,812.00	4,260.00
(ii) Asserted in petitioners' brief	\$6,734.00	6,432.00	4,140.00
(iii) Allowed by Department	\$6,734.00 ¹	9,268.00	5,234.00
<i>(12) Outside services</i>			
(i) Claimed on return	\$80,354.00	68,704.00	54,964.00
(ii) Asserted in petitioners' brief	\$76,864.00	67,327.00	48,788.00
(iii) Allowed by Department	\$76,864.00	67,654.00	65,198.00
<i>(13) Storage</i>			
(i) Claimed on return	-0-	1,210.00	-0-
(ii) Asserted in petitioners' brief	-0-	1,210.00	-0-

¹⁵ Auditor Lee had allowed 50% of petitioners' claimed car and truck expenses. The Division has agreed that petitioner may allocate 80% of such expenses to the business and therefore has increased Mr. Lee's allowance of \$4,208.00 to this greater amount of \$6,734.00.

(iii) Allowed by Department	-0-	1,256.00	-0-
<i>(14) Gifts</i>			
(i) Claimed on return	-0-	579.00	-0-
(ii) Asserted in petitioners' brief	\$950.00 ¹	-0-	-0-
(iii) Allowed by Department	-0-	-0-	-0-
<i>(15) Legal & professional services</i>			
(i) Claimed on return	\$1,413.00	-0-	750.00
(ii) Asserted in petitioners' brief	\$1,050.00	-0-	-0-
(iii) Allowed by Department	\$1,050.00 ¹	-0-	750.00
<i>(16) Local transportation</i>			
(i) Claimed on return	\$1,277.00	1,131.00	1,197.00
(ii) Asserted in brief	\$1,336.00	2,144.00	710.00
(iii) Allowed ¹⁸ by Department	\$1,277.00	1,131.00	1,197.00
<i>(17) Out of town travel</i>			
(i) Claimed on return	\$21,379.00	17,918.00	12,180.00
(ii) Asserted in brief	\$16,999.00	6,318.00	4,575.00

¹⁶ Petitioners asserted that a check in this amount, written on Mr. Townsend's personal checking account, was used to provide tips to the staff and guards at the Manhattan "Art and Antiques Centre."

¹⁷ The Division has allowed this amount based upon exhibits introduced and testimony of Mr. Townsend on October 20, 2004.

¹⁸ The Division points out that it was difficult to verify the use and amount of the receipts presented by petitioner at the hearing on October 20, 2003 and emphasizes that Mr. Townsend also claimed such expenses in his law practice. According to the Division, based on a standard of fairness it allowed what was originally claimed on the returns.

(iii) Allowed ¹⁹ by Department	\$16,999.00	600.00	1,100.00
<i>(18) Rent or lease</i>			
(i) Claimed on return	\$39,210.00	43,424.00	28,800.00
(ii) Asserted in brief	\$39,210.00	42,756.48	26,976.01
(iii) Allowed by Department	\$39,210.00	42,657.00	28,036.00
<i>(19) Supplies</i>			
(i) Claimed on return	\$21,406.00	22,460.00	7,301.00
(ii) Asserted in brief	\$14,169.00	11,383.99	3,283.40
(iii) Allowed ²⁰ by Department	\$14,169.00	5,499.00	3,283.00
<i>(20) Travel, meals & entertainment</i>			
(i) Claimed on return	\$3,272.00	650.00	2,218.00
(ii) Asserted in brief	-0-	509.00	-0-
(iii) Allowed by Department	-0-	509.00	-0-
<i>(21) Trucking, UPS & Custom fees</i>			
(i) Claimed on return	\$9,670.00	5,617.00	1,972.00
(ii) Asserted in brief	\$2,960.00	2,210.00	1,133.60
(iii) Allowed by Department	\$2,960.00	2,065.00	1,133.60
<i>(22) UBT tax</i>			
(i) Claimed on return	-0-	1,246.00	-0-

¹⁹ According to the Division, petitioners provided no back-up or third party documentation such as plane tickets and hotel room receipts or details as to when trips were taken. The Division also contends that no evidence was provided that credit card charges were actually paid. Further, according to the Division, travel expenses for Mr. Townsend who traveled abroad with Ms. Nagy were not deductible, and some portion of foreign travel was for personal interests and pleasure.

²⁰ The Division did not allow an amount of \$5,885.00 claimed as credit card purchases of supplies because it was not shown such amount was paid and no details concerning such purchases were provided. According to the Department, petitioners claimed they purchased supplies by check, credit card and petty cash. They include credit card purchases in the list of supplies they show purchased by check, and they only introduced into evidence a small fraction of receipts from their alleged purchase of supplies.

(ii) Asserted in brief	-0-	2,071.00	1,800.00
(iii) Allowed by Department	-0-	-0-	-0-

Based upon the auditor's analysis detailed above, the Division has allowed total business expenses for 1996 and 1997 computed as follows:

Expense Item	1996	1997
Advertising	\$700.00	7,139.00
Catalogues & printing	\$1,426.00	253.00
Commercial rent tax	\$597.00	-0-
Commissions & fees	\$450.00	1,800.00
Dues	-0-	-0-
Insurance	\$2,863.00	1,620.00
Miscellaneous	\$164.00	134.00
Painting & cleaning	\$389.00	-0-
Telephone	\$6,869.00	3,470.00
Utilities	\$1,182.00	777.00
Car & truck	\$9,268.00	5,234.00
Outside services	\$67,654.00	65,198.00
Storage	\$1,256.00	-0-
Gifts	-0-	-0-
Legal & professional services	-0-	750.00
Local transportation	\$1,131.00	1,197.00
Out of town travel	\$600.00	1,100.00
Rent or lease	\$42,657.00	28,036.00
Supplies	\$5,499.00	3,283.00
Travel, meals & entertainment	\$509.00	-0-
Trucking, UPS & custom fees	\$2,210.00	1,133.60
UBT tax	-0-	-0-

Totals	\$147,420.00	123,121.60
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As noted in Finding of Fact “20”, petitioners on their tax returns reported expenses of the gallery totaling \$212,789.00, \$192,721.00, and \$124,645.00, for 1995, 1996 and 1997, respectively, so that expressed in percentage format, the Division now maintains that petitioners have substantiated 83% (based upon auditor Lee’s allowance of expenses in the amount of \$176,331.00 as noted in Finding of Fact “22”), 76% and 99% of the gallery’s expenses reported on the returns for 1995, 1996 and 1997, respectively.

The Division further maintains that petitioners have failed to substantiate expenses allegedly incurred with regard to six additional categories of expenses which were not shown as categories of expenses on their tax returns. These six categories of additional expenses detailed in petitioners’ initial brief were: (1) Bank service fees and credit card fees, (2) computer expenses, (3) credit card payments, (4) license expense, (5) parking tickets, and (6) petty cash.

The Division also indicated in its brief that it would concur in petitioners’ assertion in their brief that the gallery’s gross receipts (i) for 1995 were \$616,188.00, and (ii) for the portion of 1997 when the gallery’s business was conducted as a sole proprietorship were \$279,053.00. However, for 1996, the Division contends that gross receipts were \$405,744.00 representing all the deposits determined by its auditor after an analysis of the gallery’s business checking account plus “\$1,600.00 worth of deposits that were on the gallery’s books but not in the bank statements” (Division’s brief, p. 53). In addition, for 1996, the Division has not reduced gross receipts for social security payments totaling \$9,075.00 which petitioners claim were received by Ms. Nagy on account of her daughter, Lina Mati, as detailed in Finding of Fact “30”.

According to the Division, the gallery’s inventory loss of \$324,750.00 was not allowed “since it had already been rejected by the courts for lack of evidence” (tr. 7/17/04, p. 34). Title to the goods was not established, and although the loss allegedly occurred in 1991 and 1992, it was taken in 1995.

The Division points out that on their tax returns, petitioners “carry-forward an inventory from year to year” which cannot be harmonized with the amounts they assert represent the cost of goods sold during the years at issue. The auditor was hamstrung by “the difference in numbers between the books and the returns and the lack of clarity in the purchases documents” and “acted reasonably with the information that he had” (Division’s brief, pp. 56 and 57).

32. Petitioners have conceded that when the audit first arose “our records were rather in disarray,” but that as of the start of the hearing, “what’s been surprising is how well we’ve been able to pull things together” (tr. 7/17/04, p. 20). Petitioners, likening themselves to the hunted Jean Valjean, are passionate about their feeling that the Division’s auditors are harassing them in this audit by requiring the production of back-up invoices and bills to justify such expenses as rent, utilities, telephone, insurance, etc. when checks paid for such expenses should have been adequate proof since the gallery is an on-going business and the gallery’s expenses for the year 1995 have already been thoroughly audited. Nonetheless, petitioners emphasize that the parties have reached the point where they are essentially in agreement with only minor differences on the gallery’s income, purchases, costs of goods sold, three of the four losses claimed, and for the most part, the gallery’s ordinary and necessary business expenses. According to petitioners, there are only “two significant issues” to be resolved: (1) the disallowance of purchases to create over \$330,000.00 of phantom income, and (2) the deductibility of the Gallery’s loss of \$322,950.00 of inventory in 1995 (petitioners’ reply brief, p. 40). Of the 22 categories of expenses noted in the table in paragraph “31”, petitioners point out that the parties are now in agreement that expenses in 16 categories are deductible by the gallery during the period at issue in the amounts shown in such table. Only the following six categories of expenses listed in the chart remain in dispute: (1) gifts, (2) local transportation, (3) out-of-town travel, (4) supplies, (5) trucking, UPS & custom fees, and (6) UBT tax. With regard to these six categories, petitioners argue as follows:

- (1) Gifts- Mr. Townsend's personal check for \$950.00 was used "to make Christmas tips on behalf of the Gallery" (petitioners, reply brief, p. 31);
- (2) Local transportation- Limiting such expenses to the amounts claimed on their tax returns is wrong based on the testimony of Ms. Nagy;
- (3) Out-of-town travel- Petitioners agree to the lesser amount of \$600.00 allowed against their claimed \$6,318.00 for 1996 and the amount of \$16,999.00 previously allowed by auditor Lee for 1995, but assert that four items for 1997 were "clearly out-of town travel expenses: AutoEurope \$100.00, Flytime \$700.00, AutoEurope \$1,000.00 and Flytime \$2,360.00, or an aggregate of \$4,167.00" (petitioners' brief, p. 32);
- (4) Supplies- Petitioners point out that the parties have reached agreement concerning expenses for supplies of \$14,169.00 for 1995, and \$3,283.00 for 1996 and contend that the Division should allow the full \$11,383.99 it asserted in its initial brief and not merely \$5,499.00 as noted in the table above;
- (5) Trucking, UPS & Customs fees- a disputed expense in 1996 of \$145.00 was paid by credit card and should be allowed; and
- (6) Unincorporated business tax- two personal checks of Mr. Townsend established that such tax was paid in 1996 and 1997.

With regard to the six categories of additional expenses detailed in petitioners' initial brief which were not shown as categories of expenses on petitioners tax returns, petitioners challenge the Division's disallowance of any expenses in these categories for the following reasons:

- (1) Bank service fees and credit card fees- Bank charges of \$242.87 and \$378.20 should be allowed for 1996 and 1997, respectively, because "fees and interest on unpaid balances are ordinary and necessary business expenses" (petitioners' reply brief, p. 34);
- (2) Computer expense- Ms. Nagy's check in the amount of \$180.00 was a business expense related to a computer used in the business;
- (3) Credit cards- Payments on credit cards totaling \$14,946.00 in 1996 and \$4,232.68 in 1997 were for various business expenses of the gallery ranging from supplies to out-of town travel;
- (4) License expense- Ms. Nagy's check in the amount of \$340.00 in 1997 to the Department of Consumer Affairs should be allowed in a similar way that auditor Lee allowed \$455.00 in 1995;
- (5) Parking tickets- Parking tickets paid in the amounts of \$265.00 and \$165.00 for 1996 and 1997 were business expenses incurred "in stopping to pick up and drop off merchandise" (petitioner's reply brief, p. 33);

(6) Petty cash- reducing entertainment expenses claimed paid in this category by 50% and conceding that the amounts claimed include payments made by credit cards and a purchase included in 1996 was for inventory and should not be included here, petitioners now argue they are entitled to deductions in this category of \$1,013.00, \$1,572.00 and \$983.00 for 1995, 1996, and 1997, respectively.

With regard to the theft lost claimed of \$324,750.00, petitioners reject the Division's position that a theft loss must be deducted in the year it occurred or was discovered. Rather, citing Treasury Regulation § 1.165-1(d)(2)(i), they contend that a theft loss may only be deducted when there "clearly can be no further recovery" (tr. 7/17/04, p. 134). They also argue that Ms. Nagy has proven that she had title to the inventory that had been stolen.

Petitioners concede that the amounts they now claim for the gallery's cost of goods sold for each of the respective years are higher than the amounts shown on their returns. Nonetheless, according to petitioners, they have proven their cost of goods sold at the hearing by matching each sale with the corresponding cost of the item sold, as reflected in the gallery's inventory book.

CONCLUSIONS OF LAW

A. When the Division issues a Notice of Deficiency to a taxpayer, a presumption of correctness attaches to the notice, and the burden of proof is on the taxpayer to demonstrate that the deficiency assessment is erroneous by clear and convincing evidence (*Matter of O'Reilly*, Tax Appeals Tribunal, May 17, 2004).

B. Under Tax Law § 612(a), the adjusted gross income of a New York resident is Federal adjusted gross income, with certain modifications not applicable in this case. Section 62(a)(1) of the Internal Revenue Code ("IRC") defines the adjusted gross income as an individual's gross income minus certain deductions. Among the deductions permitted are deductions for expenses which are "ordinary and necessary" for the production or collection of income (IRC § 212[1]). The taxpayer has the double burden of (1) demonstrating entitlement to the deduction and (2)

substantiating the amount of the deduction (*see*, Tax Law § 658[a]; § 689(e); 20 NYCRR 158.1; *Matter of Macaluso*, Tax Appeals Tribunal, September 22, 1997 *confirmed* 259 AD2d 795, 686 NYS2d 193). Furthermore, petitioners were required to maintain adequate records of the Gallery's items of income, loss and deduction for the years in issue (Tax Law § 658[a]; 20 NYCRR 158.1[a]).

C. Here, petitioners complain that they feel harassed by the Division which, as detailed in the Findings of Fact, has persisted in its demands that petitioners bring forward third-party documentation such as bills and invoices in support of the various expenses claimed incurred by Ms. Nagy's gallery. Petitioners are extremely busy individuals in their careers and during the period of the audit in particular had many demands on their personal life, and they resisted the Division's demands. They simply could not understand why the Division would continue to demand such records when the gallery has been in operation for so many years and has established that it incurs expenses such as rent, utilities, telephone, insurance, etc. They contend that checks paid for such expenses should have been adequate proof especially after they brought forward such documentation for the first year at issue. Petitioners' resistance, when the tax returns they filed for the years at issue were clearly *not accurate* with regard to the operation of Ms. Nagy's gallery, resulted in a hostile relationship with the original auditor, who died in the terror attacks of September 11, 2001, and with the succeeding auditor, who understandably felt defensive about the original audit and the reputation of the original auditor. Nonetheless, the pivotal point is that the Division's auditor had the authority and discretion to seek such third-party documentation, and ultimately, petitioners would bring forward such documentation. However, as a consequence of this hostile relationship with the Division's auditors, an audit, which should have been performed prior to the hearing, was conducted during the course of this proceeding.

D. As noted in detail in the Findings of Fact, the parties have managed to make substantial progress in reaching agreement on the gallery's business expenses once the Division was able to conduct the detailed audit of expenses it had demanded of petitioners since its letter of January 28, 1999, as noted in Finding of Fact "5". In fact, with their reply brief, petitioners emphasized that only a few category of expenses remain at issue. With regard to 22 categories of expenses shown as categories of expense on petitioners' original tax returns, as noted in paragraph "31", the parties are now in agreement with regard to 16 categories. With the remaining 6 categories, the Division provided the following reasons for disagreeing with the amounts claimed by petitioners after its careful review of documents brought forward by petitioners during the hearing process:

(1) Gifts- Mr. Townsend's personal check in 1995 for \$950.00 made out to cash which he testified was cashed in order to provide tips to the staff and guards at the Manhattan Art and Antiques Centre was based only upon his vague testimony;

(2) Local transportation- The Division only allowed such expenses up to the figures shown on petitioners' tax returns "because there was no way to know if these particular receipts were from Ms. Nagy's business or Mr. Townsend's law practice or were even used for business purposes" (Division's brief, p. 23). According to the Division, it was fair to allow what was originally claimed when it was so difficult to verify the use and amount of the receipts since some are impossible to read and nothing was claimed on the books for 1996 and 1997;

(3) Out-of-town travel- 1995 and 1996 are no longer in dispute. With reference to 1997, petitioners have significantly altered the amount claimed and only \$1,100.00 as detailed in the books for 1997 should be allowed since no specific explanation such as details "as to when trips were taken or how long the petitioners were gone" and suggests further that European travel "was not all business" and "travel expenses for Mr. Townsend are not deductible" (Division's brief, p. 26);

(4) Supplies- Alleged credit card payments for supplies were disallowed because "it is not clear whether the credit card charges were ever paid, it is not clear what each expense was, it is not clear where and when the expense was purchased, and it was not clear whether the expense was ordinary and necessary" (Division's brief, p. 28). The Division allowed \$3,283.00 for supplies expenses in 1997 which was more than the total of \$2,270.00 for the receipts the auditor reviewed because the higher amount was the figure on the books and "it is not clear where the overlap is with the alleged supplies expenses as to the three

methods of payment,” i.e., (i) on the books, by business check, as a supplies expense, (ii) petty cash, and (iii) credit cards. The Division argues that petitioners supplied only a limited amount of third-party documentation and “it is impossible to see which supply purchases are legitimate” and if there is “duplication” since some alleged supply purchases made by credit card are included in “petty cash” and the category of “credit cards expenses” as well (Division’s brief, p. 29);

(5) Trucking, UPS & customs fees- A credit card payment of \$145.00 was disallowed “because it is not clear whether the credit card charges were ever paid, it is not clear what each expense was, and it is not clear when the expense was purchased” and this charge might be duplicated in the separate credit card expense category (Division’s brief, p. 31);

(6) Unincorporated business tax- Amounts claimed in payment of this tax do not match up with unincorporated business tax returns or other clear substantiation;

With regard to the six categories of additional expenses detailed in petitioners’ initial brief which were not shown as categories of expenses on petitioners’ tax returns, the Division rejected petitioners’ claims for the following reasons:

(1) Bank service fees and credit card fees- Insufficient evidence provided that specific fees were incurred by the gallery since petitioners appear to have eight credit cards and multiple checking accounts;

(2) Computer expenses- No invoice presented or other evidence that a computer is used in the business emphasizing that inventory sheets are done by hand and Ms. Nagy’s testimony on this expense was vague;

(3) Credit cards- Inadequate proof that credit card charges made to eight credit card companies were expenses “for business purposes and . . . ordinary and necessary” with much evidence that such charges were personal or private, and “credit card payments as its own separate expense” conflicts with petitioners’ utilizing the 26 categories shown above (Division’s brief, p. 37);

(4) License expense- Books detail a license expense of \$340.00 by a check #2259 which in fact is a check for \$900.00;

(5) Parking tickets- Not deductible since “paid to a government agency for the violation of a law” and inadequate details concerning when they were incurred (Division’s brief, p. 40);

(6) Petty cash- Records provided to substantiate in major disarray and impossible to audit.

It is concluded that petitioners have not established that they are entitled to additional Schedule C expense deductions over and above those which have been allowed by the Division after its review of the documentation submitted by petitioners in this proceeding for the reasons noted by the Division above for its rejection of such additional deductions. The Division has adequately explained why such evidence was inadequate. Petitioners' evidence simply does not rise to the level of sustaining their burden to prove that any further adjustment is in order (*see, Matter of Cass*, Tax Appeals Tribunal, June 10, 2004). In particular, petitioners' "off-the-business-books" evidence was oftentimes not maintained in a manner subject to review and verification as required.

E. Further, as noted in paragraph "31", the parties have also reached substantial agreement on the gallery's gross receipts. Nonetheless, for each of the years, its gross receipts were in excess of what was reported on petitioners' tax returns as follows:

Year	Reported on tax returns	Agreed amounts
1995	\$ 544,660.00	\$ 616,188.00
1996	\$ 338,040.00	\$ 405,744.00 according to Division; \$ 395,069.00 according to petitioners (excluding Social security payments of \$9,075.00 and \$1,600.00 worth of deposits not in bank statements but on books)
1997	\$ 244,633.00	\$ 279,053.00

Expressed in percentage format, petitioners underreported the gallery's gross receipts on their tax returns by approximately 12% in both 1995 and 1997 and by 17% in 1996 if the Division's figure is used or by 14% if petitioners' figure is used. In addition, the Division's use of the higher amount of \$405,744.00 is proper based upon the lack of clear and convincing evidence why \$9,075.00 in social security payments would be funneled through a business checking account and sufficient details concerning such payments and why the amount of \$1,600.00 was shown on the books.

F. Petitioners from early on in the audit process wanted the auditor to focus on the substantial theft loss claimed of \$324,750.00 which would make the audit of expenses, according to Mr. Townsend, “meaningless, because there is a huge carry forward.” Frustration ensued for petitioners when the auditor rejected this claim, and petitioners pressed for resolution of this issue before proceeding with the audit of expenses. However, as noted in footnote “5”, there is no basis in the Tax Law or regulations that permits the resolution of one issue prior to a hearing on other issues. Consequently, the audit of the gallery’s business expenses could not be put aside pending resolution of this substantial claim, but now the issue of the theft loss may be addressed.

G. Under IRC § 165(e), deductions for theft losses are permitted. As detailed in Findings of Fact “1”, “2” and “29”, petitioners have established with great detail the scheme by Ms. Nagy’s stepdaughter and Mr. Ayvazian to convert to their own use and profit a considerable number of valuable rugs from the gallery’s inventory. Their motivation is clearly established by their resentment breeding from Ms. Nagy’s inheritance of the gallery’s inventory as detailed in the Findings of Fact. Further, Ms. Nagy’s detailed testimony concerning the specific rugs stolen and her attempt to get reimbursement was credible and unshakeable despite a vigorous cross-examination on the subject. In addition, petitioners have established that the deduction for this theft loss in the amount of \$324,750.00 may properly be taken in 1995, the year when the possibility of recovery was shown to have become impossible given Mr. Ayvazian’s lack of assets and the inability to recover from third parties as a result of the stepdaughter’s willingness to deceive by concocting documents as established in 1995 by petitioners’ actions to gain compensation for the theft (Treas Reg § 1.165-1[d]; Federal Tax Coordinator 2d [RIA] ¶M-2136).

As a general rule, the theft loss deduction does not apply to a theft of property reflected in the inventories of the taxpayer (Treas Reg § 1.165[8][e]). However, this rule of limitation

applies when the taxpayer has “expensed the [inventory] items on her business return as a cost of goods sold” (Federal Tax Coordinator 2d [RIA] ¶ M-2131). In the matter at hand, Ms. Nagy’s method of calculating her cost of goods sold was based on a specific matching of the item sold and its cost basis at the time of the sale. Her inventory was not expensed as a cost of goods sold at the time of purchase and therefore this limitation is not applicable here.

As noted in paragraph “28”, the Division has agreed that petitioner incurred the three smaller losses at issue. Consequently, the Division is directed to allow petitioners the four losses claimed from 1995 as theft loss deductions in such year which may be deducted from the gallery’s gross income in such year by the total amount of the four losses. It is noted that pursuant to Tax Law § 687(f), a determination may be made that a taxpayer has made an overpayment for a tax year for which a timely petition has been filed so that the period of limitations for claiming a refund is not an issue.

H. As noted in Finding of Fact “19”, the Division increased petitioners’ New York taxable income by adding an amount equal to “purchases disallowed” of \$172,586.00, \$155,188.00 and \$1,690.00 for 1995, 1996 and 1997, respectively. Petitioners are correct that a disallowance of purchases of merchandise which go into inventory does not increase income here, because petitioners did not expense amounts representing the gallery’s purchases. Rather, as discussed above, the cost of goods sold by Ms. Nagy’s business was based upon a specific identity or matching method of accounting. The particular item sold was identified by petitioners with its specific cost to the business or, if it was an item inherited by Ms. Nagy from her first husband’s estate, to its fair market value, as of the date of his death. With regard to the sale of an item consigned to the gallery by other dealers, the consignment price paid at or shortly after the sale of such item is noted. Consequently, petitioners have shown that the Division erroneously increased petitioners’ New York taxable income by adding an amount equal to “purchases disallowed.”

I. As detailed in Finding of Fact “27”, petitioners have established the cost of goods sold for each of the years at issue by the testimony of Ms. Nagy and her explanation of the three detailed documents created for purposes of the hearing which list the particular items sold and the basis or cost for each item. Since it may be concluded that petitioners’ methodology for determining the gallery’s cost of goods sold clearly reflects the gallery’s income, the Division may not compel petitioners to utilize the more traditional methodology as noted in Footnote “1” (*see*, Mertens, Law of Federal Income Taxation, § 12:25). Further, the Division’s auditor questioned some of the details listed in these voluminous exhibits, but petitioners have provided an adequate explanation in a detailed rebuttal appended to their reply brief for the items questioned, except for one item #654 which had a cost of \$300.00. Petitioners agree with the auditor that the cost of this item should not have been included in its listing of cost of goods sold for March of 1996.

J. Petitioners assert that “last, but not least” they claim credit for an overpayment of \$7,616.00 on their 1994 tax return which they seem to suggest was not applied by the State to their 1995 State income tax. As detailed in Finding of Fact “19”, petitioners have been credited in each of the three years at issue for tax “previously paid” with the filing of the respective tax return. Any overpayment of 1994 tax, which petitioners on their 1994 return might have requested to have credited to their 1995 tax, should have been part of their computation to determine the tax “previously paid” for 1995 on their 1995 return. In any event, this assertion is based on an Exhibit “1”, which was marked for identification but *never introduced* into evidence. Consequently, this “last, but not least” request for credit is therefore denied.

K. After the Division recalculates petitioners’ income tax liability for the years at issue, negligence penalty may be imposed on any deficiency that may result in light of the inaccurate returns filed by petitioners in the first instance with regard to the operations of Ms. Nagy’s gallery. If petitioners had clearly disclosed their less-than-common methodology for computing

the gallery's cost of goods sold, perhaps in a rider included with their return, and had claimed the theft loss of \$324,750.00 on their 1995 return as filed, the Division's auditors might have pressed them less vigorously concerning their claims. Petitioners' claim that they did not include this theft loss on their return initially because they did not want to attract the attention of tax auditors given the demands of their careers and personal life is indeed ironic. Finally, the issue concerning the imposition of a penalty for substantial underpayment of tax is rendered moot.

L. The petition of R. Edward Townsend, Jr. and Suzanne C. Nagy is granted to the extent indicated in Conclusions of Law "D", "E", "G", "H" and "I", and the Notice of Deficiency dated June 18, 2001 is to be modified to so conform, but, in all other respects, is denied.

DATED: Troy, New York
October 28, 2004

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE